

FYI – For Your Information

Investment Tax Credit

This publication includes information on three Colorado investment tax credits (ITC) available that relate to the federal business investment tax credit:

- Enterprise zone investment tax credit,
- New investment tax credit,
- Old investment tax credit.

ENTERPRISE ZONE INVESTMENT TAX CREDIT

The enterprise zone investment tax credit is three percent of any qualified investment in section 38 property:

- acquired and placed in service or constructed during the tax year, and
- used exclusively (100%) in a Colorado enterprise zone for the first year of its ownership by the taxpayer. [§39-30-104 (1) C.R.S.]

Limitations

The credit is not computed on the full value of 3-year recovery property or on non-recovery property with a useful life of less than seven years. See "Qualified Investments" for details.

The enterprise zone investment tax credit with respect to any qualified investment is in lieu of any old investment tax credit otherwise allowed with respect to the same expenditure. [§39-22-507.5 C.R.S.]

Relocation

Generally, no enterprise zone investment tax credit shall be allowed if the investment resulted from the relocation of a business operation from within the state to an enterprise zone. This is regardless of whether the original location of the operation was within an enterprise zone.

Once the new location is established, additional qualified investments will once again qualify for the investment tax credit. This restriction also applies to assets purchased during the relocation of a portion of a facility. [§39-30-104(6) C.R.S.]

However, if the relocation meets the criteria for a "qualified expansion facility" for the enterprise zone new business facility credit, then the investments that result from the relocation will qualify for the enterprise zone investment tax credit. (This is the case even if the business was qualified as a new business facility prior to the relocation.) To qualify, the taxpayer must have invested at least \$1 million or, if less, 100 percent of the investment in the old facility, or increased employment by 10 employees or 10 percent over the previous 12-month average.

Tax Liability Limitation

For years beginning on or after Jan. 1, 1996, the credit is allowed to the extent of the first \$5,000 of tax liability, plus 50 percent of the liability in excess of \$5,000.

For tax years beginning prior to Jan. 1, 1996, the Enterprise Zone Investment Tax Credit could be claimed to the extent of the first \$5,000 of tax liability plus 25 percent of the liability in excess of \$5,000.

If you have more ITC than you can claim based on the limits of your tax liability in a particular year, you can carry the unused amount of your ITC back three years and forward up to twelve years (seven years for credits earned in taxable years beginning prior to Jan. 1, 1996).



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Motor Vehicles

A vehicle that operates out of an enterprise zone facility will *not* qualify for the enterprise zone investment tax credit if it is driven outside the zone at any time during the first year of service.

Documentation

If you claim an enterprise zone investment tax credit of \$450 or more, attach a copy of Form DR 0074 "Certification of Qualified Enterprise Zone Business" signed and certified by the zone administrator to your Colorado income tax return. If you file electronically, keep a copy of Form DR 0074 with your tax records. You must provide a copy to the Department of Revenue if requested.

NEW INVESTMENT TAX CREDIT

The new Colorado investment tax credit is allowed in an amount equal to 1% of the total qualified investment as determined under section 46(c) of the internal revenue code in qualified property as defined in section 48 of the internal revenue code as such sections existed prior to the Revenue Reconciliation Act of 1990. The new ITC is basically 10% of what the federal regular percentage ITC would be if it were still in effect. This credit was implemented in 1988 to provide an ITC on equipment that no longer qualified for the old ITC that was reduced by federal law changes in 1986. [§39-22-507.6 C.R.S.].

Limitations

The new investment tax credit is limited to \$1,000 reduced by the amount of the old investment tax credit claimed for the same tax year. Any excess new investment tax credit remaining may be carried forward for a period of three years. It may not be carried back to an earlier year.

The new Colorado investment credit is allowed only with respect to assets located within Colorado. If qualifying property is located both within and without Colorado during the tax year, the credit shall be apportioned based on the time of usage of such property in Colorado during the tax year as compared with the total time of usage of such property everywhere during the tax year unless the taxpayer can justify a more equitable apportionment method.

The credit is available only to C corporations.

All Internal Revenue Code section 46 (as such section existed prior to 1990) restrictions on qualified investment apply for purposes of the new ITC. For example, only a fraction of the basis or cost of assets that have a useful life of less than seven years qualifies for the credit, only \$150,000 of used property may qualify for the credit, and any amounts expensed under section 179 of the Internal Revenue Code do not qualify.

OLD INVESTMENT TAX CREDIT

The old investment tax credit is 10% of the current year federal investment credit, which includes the rehabilitation, energy and reforestation investment credits on assets located in Colorado. [§39-22-507.5 C.R.S.]

Limitations

The current year credit is the sum of the old investment tax credit carryforward, the current year old investment tax credit and the old investment tax credit carryback. The credit is limited to the first \$5,000 of tax liability plus 25% of the tax in excess of \$5,000. The credits must be utilized in the order they were created. Excess credit may be carried back three years and forward seven.

The credit is available only to C corporations.

QUALIFIED INVESTMENTS

The value of investments must be reduced before the three- percent enterprise zone ITC rate or one- percent new ITC rate is applied if the depreciable life of the asset falls into certain categories.

In the case of section 38 recovery property, the amount of qualified investment is computed as follows:

- 1) 60 percent of the basis for new 3-year recovery property.
- 2) 100 percent of the basis for all other new property in recovery classes of more than 3 years.
- 3) 60 percent of the cost of used 3-year recovery property and/or 100% of the cost of all other used recovery property up to a maximum of \$150,000.

In the case of section 38 property that is not recovery property, the cost or other basis (including up to \$150,000 of used property) that qualifies is limited if the property has a useful life of less than seven years. Only two-thirds of the basis or cost is taken into account if the useful life is at least five and less than seven years. Only one-third is taken into account where the useful life is at least three and less than five years. No credit is allowed if the useful life is less than three years.

Under certain circumstances the taxpayer may claim the credit on leased property. See "Leased Property" later in this publication for details.

All other Internal Revenue Code section 46 (as such section existed prior to 1990) restrictions on qualified investment also apply for purposes of the Colorado enterprise zone investment tax credit. For example, any amounts expensed under section 179 of the Internal Revenue Code do not qualify.

Example: PQR Company, a C corporation, purchases two pieces of equipment during the tax year. Item 1 is classified as three-year recovery property with a basis of \$10,000 while item two qualifies as five-year recovery property with a basis of \$7,000. The credit will be computed as follows:

Item 1 $\$10,000 \times 60\% = \$6,000$

Item 2 $\$7,000 \times 100\% = \$7,000$

Total value of investments for ITC computation \$13,000

$\$13,000 \times 3\% = \390 enterprise zone investment tax credit.

$\$13,000 \times 1\% = \130 new investment tax credit.

SECTION 38 PROPERTY

"Section 38 property" is defined in section 48 of the Internal Revenue Code as that section existed prior to 1990.

Section 38 property is either federal recovery property or other depreciable or amortizable property having a useful life of three years or more that qualifies under one of the following eight categories:

1) Tangible personal property.

a. In general, tangible personal property

used in a taxpayer's trade or business is section 38 property. This includes items such as machinery, furniture, appliances, law books or vehicles. (Remember, vehicles and other mobile property must be used solely and exclusively within an enterprise zone for at least the first 12 months of service to qualify for this credit.)

Three specific items of tangible personal property excluded from the definition of section 38 property are:

i. air conditioning units,
ii. heating units, and
iii. certain boilers fueled by petroleum or petroleum product that fail to meet special qualifications (old federal code section 48(a)(10)).

b. Livestock. Depreciable livestock (not including horses) is section 38 property if it has at least a three-year useful life. However, if within a one-year period starting six months before the date of acquisition, substantially identical livestock is disposed of without any federal investment tax credit recapture, the credit will be allowed only on the excess of the cost of the acquired livestock over the amount realized on the disposition. The age and sex of the livestock, and the use to which it is put, determine whether the livestock disposed of is substantially identical.

c. Lodging. Tangible personal property used predominately to furnish lodging (or in connection with furnishing lodging) is not section 38 property except when such property is used in connection with a hotel or motel furnishing accommodations predominately to transients. However, coin operated vending machines, washing machines and dryers are section 38 property even when they are used in connection with the furnishing of lodging. Tangible personal property used as part of the rehabilitation of certified historic structures is section 38 property even though the structure is used to furnish lodging. Also, non-lodging commercial facilities, such as tangible personal property in a drug store or restaurant situated in an apartment building or hotel, can qualify as section 38 property if they are available to persons not using the lodging facilities.

2) Other tangible property. Other tangible property (including real property but not including a building or its components) is

section 38 property if it is used as an integral part of:

- a. manufacturing,
- b. extraction,
- c. production, or
- d. furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services.

This category would include such things as blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, broadcasting towers, oil derricks, and fences used to confine livestock.

3) Elevators and escalators. Elevators and escalators are specifically included in the definition of section 38 property.

4) Research facilities and facilities for the bulk storage of fungible commodities. Research facilities and facilities for the bulk storage of fungible commodities (including liquids or gases) are section 38 property but only to the extent they are used in connection with the activities described in category 2) above. Fungibles are commodities, such as oil or grain, that can be mixed together. Later, they can be returned to parties in the mixed state. For example, if two people put grain in a grain silo, they could each pull out the original amount put in, but the grains would be mixed.

5) Single purpose agricultural or horticultural structures. Single purpose agricultural or horticultural structures may be section 38 property. A single purpose agricultural structure is section 38 property if it is designed, constructed, and used for housing, raising and feeding a particular type of livestock, such as cattle, pigs, or poultry, and their produce, and housing the equipment necessary for the particular activity.

A horticultural structure is section 38 property if it is specifically designed, constructed, and used for the commercial production of plants and/or mushrooms. Work space in the structure is permitted if such space is used solely for stocking or caring for livestock or plants, for collecting their produce or for maintaining the structure and equipment or stock housed in it.

6) Qualified rehabilitation expenditures. Qualified rehabilitation expenditures are section 38 property.

7) Qualified timber property. Qualified timber property for which amortization is claimed under Internal Revenue Code

section 194 is section 38 property.

8) Petroleum storage facilities. Storage facilities used in connection with the distribution of petroleum or its primary products are section 38 property.

LEASED PROPERTY

The owner of the property may claim the enterprise zone or new ITC, or elect to pass on the investment credit to the lessee of the property if the leased property is new section 38 property and is qualifying property both to the owner and to the lessee. A lessor cannot pass on the credit for used property to the lessee.

Non-corporate lessors and S Corporation lessors are eligible for the investment credit only if:

- the leased property has been manufactured or produced by lessor, or
- the term of the lease is less than 50 percent of the January 1, 1986 Asset Depreciation Range (ADR) class life for recovery property (useful life for other property) of the leased property,

and also

- the lessor's business expense deductions (other than rental payments and reimbursed expenses) related to the property are more than 15 percent of the rental income from the property for the first year of the lease.

If the lessor is denied the credit under this provision, the lessor may still pass the credit through to the lessee.

Where new section 38 property with an ADR class life of more than 14 years is leased (not a net lease) for a period which is shorter than 80 percent of its class life, the lessor may pass through to the lessee only that portion of the credit which the lease period covers.

The investment tax credit will not be allowed when a tax-exempt organization sells depreciable property to pass the tax benefits to the new owners and then leases back the property.

It is advisable that the lessor and lessee maintain some form of a legal agreement if the credit is passed to the lessee.

However, there is no requirement as to what is required and no official form for this purpose.

INVESTMENT TAX CREDIT RECAPTURE

Enterprise zone ITC

There is no recapture provision for the enterprise zone ITC. If the credit is claimed on property that is not used exclusively in the enterprise zone for at least one year, or if the credit is determined to be claimed in error for any other reason, the income tax return on which the credit was originally claimed must be amended to reduce the ITC claimed to the correct amount.

New ITC

There is no recapture provision for the new ITC. If it is determined that the credit was claimed in error the income tax return on which the credit was originally claimed must be amended to correct the ITC claimed.

Old ITC

Any corporation required to redetermine the federal credit upon which the Colorado old ITC was previously claimed due to provisions of section 50 of the Internal Revenue Code (section 47 for tax years prior to 1991) must redetermine the Colorado credit for the same tax year in accordance with the applicable federal recapture percentage table. If such redetermination results in a reduction of the Colorado credit, such reduction shall constitute an increase in Colorado income tax for the year during which the disposition or reclassification of the nature of the property occurs, and the amount of any unused ITC carryback or carryforward must be recomputed. Such increase shall be reported on the credit recapture line of the Colorado income tax return, but shall not be included as tax liability for purposes of computing the limitations on current year credits.

SPECIAL RULES

In the case of a controlled group of corporations as defined in section 1563(a) of the Internal Revenue Code, the \$1,000, \$5,000 and \$150,000 credit limitations shall be apportioned among the members of the controlled group as they may elect. The election shall apply to the income tax year of the members of the group ending with or including a common December 31. Should such members fail to agree on an

allocation of the limitation amount, it shall be divided equally among all members of the controlled group.

In the case of a regulated investment company or a real estate investment trust, the \$5,000 credit limitation shall be reduced to an amount which shall be \$5,000 multiplied by the taxable income for the income tax year and divided by the taxable income for the income tax year plus the deduction for dividends paid.

No carryforward or carryback of unused investment credit will be allowed in the case of a taxable cooperative as defined in section 1381(a) of the Internal Revenue Code of 1954, as amended.

When a tax-exempt entity sells depreciable property to pass the tax benefits to the new owners and then leases back the property, the investment tax credit will be denied for the property.

No investment tax credit is allowed to the purchaser of used property if the property is used by a person who used it before the purchase or by a related person. This would include a leaseback of used property or a purchase of leased property by the lessee.

No investment tax credit is allowed for Section 38 property to the extent such property is financed with nonqualified nonrecourse financing. This limitation applies to certain closely held corporations engaged in business activities that are subject to the loss limitation at-risk rules of Internal Revenue Code Section 465.

COMMON QUESTIONS

Can the enterprise zone investment tax credit and the new corporate one- percent investment tax credit be claimed for the same property?

Yes. However, only C corporations may claim the new investment credit. The old investment credit and the enterprise zone investment credit may not be claimed on the same property.

Does claiming an investment tax credit reduce my tax basis in the property?
No.

Can tangible property expensed under Section 179 be used to claim an investment tax credit?
No.

Does computer software qualify for the investment tax credit?
Only if the software qualifies as Section 38 property. Generally, software does not qualify for the credit.

A C corporation has an unused investment tax credit available to carry forward from its 2004 return. In 2005 the corporation elects to be taxed as an S Corporation. Can the credit be carried forward and claimed on the S Corporation return in 2005?

No, the credit cannot be carried forward from a C corporation to an S corporation return.

Does the purchase of equipment included in the purchase of a business qualify for the investment tax credit?
Yes, although the total investment in used equipment is limited to \$150,000 per year.

Must a taxpayer deduct the federal "Bonus Depreciation" before calculating the investment tax credit?
No, the federal "Bonus Depreciation" deduction does not affect the investment tax credit computation.

In what tax year should work in progress be claimed for the investment tax credit?
The general rule requires an asset to be placed in service prior to the credit being claimed. However, federal rules provide an exception for certain projects that have a normal construction period of over two years that allows a portion of the credit to be claimed prior to the asset being placed in service. Refer to the IRS rules and code for details on this exception.

FURTHER INFORMATION

FYIs and commonly used forms are available online at www.taxcolorado.com

More information is available through the Colorado Office of Economic Development located at 1625 Broadway, Room 1700, Denver, CO 80202; (303) 892-3840. You may also visit the OED Web site at www.advancecolorado.com/ enterprisegone.com/ for more information on Colorado Enterprise Zones.

For additional Colorado income tax information visit the "Tax Information Index" which covers a variety of topics including links to forms, publications, regulations, statutes and general questions and answers. The "Tax Information Index" is located at www.taxcolorado.com

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